No. 89-1613

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1989

R. RICHARD BASTIAN, III, B.P. LOUGHRIDGE, M.D., RONALD D. ROTUNDA, MARCIA ROTUNDA, GENERAL SYNERGY INVESTMENTS, GABRIEL FERNANDEZ, J. MAHAR, CMF ASSOCIATES, ALFRED J. HENDRON, JR., and M.T. DAVISSON,

*Petitioners,*

vs.

PETREN RESOURCES CORPORATION, an Illinois Corporation, FAESTEL INVESTMENTS, INC., an Illinois Corporation, DAVID J. FAESTEL, and McDERMOTT, WILL & EMERY, a Partnership,

*Respondents.*

## RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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## TABLE OF CONTENTS

APPENDIX

## TABLE OF AUTHORITIES

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## RESPONSE TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

## STATEMENT OF THE CASE

Many of the "factual" assertions made in Petitioners' Statement of the Case and throughout the Petition are incorrectly stated. Most of these discrepancies are addressed in the body of this Response. However, Petitioners' misstatements concerning the allegations of the Complaint and Amended Complaint stand out because they are repeated throughout the Petition and permeate the entire argument. Accordingly, Respondents single out those misstatements and address them here.

Petitioners wrongfully state that their Complaint and Amended Complaint alleged:

- that Petitioners were told that their investments would be "managed by able and experienced industry experts" (Petition, p. 17); and
- that the promoters were, in fact, incompetent and inexperienced (*Id.*).

Petitioners then imply (though never directly argue) that these allegations are sufficient to allege "loss causation". Yet, neither of these allegations appear in the Complaint or Amended Complaint.[1]

With respect to the first "allegation" as to what Petitioners "were told," neither the Complaint nor the Amended Complaint alleged or complained of *any* affirmative representation, let alone a representation concerning the promoters' competence or experience as experts.

[1] The Complaint is the only pleading in which Petitioners attempted to assert a claim under the federal securities laws. Those claims were not reasserted in the Amended Complaint, which was limited to claims under RICO and state law.

The same is true as to the second so-called "fact" or "allegation." Nowhere in the Complaint or Amended Complaint did the Petitioners allege that the promoters were "incompetent," "inexperienced" or anything of the kind. The Complaint alleged three specific non-disclosures, none of which had anything to do with the competence or operating experience of the promoters. (Complaint, ¶ 18, App. 4.) The first had to do with a 1979 lawsuit against two of the promoters, Faestel Investments, Inc. ("FII") and David Faestel ("Faestel"); but the lawsuit did not concern the promoters' competence or experience as operators or managers of oil and gas ventures. (Complaint, ¶ 18(a), App. 4.) The second related solely to an alleged default on a loan related to other ventures and, again, had nothing to do with the competence or experience of the promoters as operators or managers of oil and gas ventures. (Complaint, ¶ 18(b); App. 4.) The third had to do solely with Petren Resources Corp. ("Petren"), the corporate general partner. (Complaint, ¶ 18(c); App. 4.) The allegation was that Petren had been formed as the alter ego of Faestel and FII solely with respect to the Petren programs. Although this allegation arguably related to the experience of *Petren* as a corporate entity, the whole premise of the allegation was that Petren was nothing more than the alter ego of Faestel and FII. Thus, the allegation was self-defeating as to the question of experience because, according to Plaintiffs, it was Faestel and FII who were operating and managing those programs, albeit through Petren's corporate structure.

Indeed, in dismissing without prejudice the Complaint's securities law claims, the district court expressly allowed Plaintiffs the opportunity, if they could do so, to amend their claims to allege that Respondents were "incompetent or irresponsible" and that such incompetence had caused the investment to fail. *Bastian v. Petren Resources Corp.*, 681 F.Supp. 530, 536 (N.D.Ill. 1988). However, Petitioners

did not do so. Instead, in the Amended Complaint they repeated the *identical* three alleged non-disclosures (Amended Complaint, ¶17, App. 21), and abandoned their securities fraud claims altogether. *Bastian v. Petren Resources Corp.*, 699 F.Supp. 161 (N.D.Ill. 1988).[2]

Indeed, any remaining doubt as to whether Petitioners alleged "loss causation" is resolved by Petitioners' own admission in the Seventh Circuit:

> Plaintiffs [*i.e.*, Petitioners] concede that they did not allege "loss causation" in either their original or amended complaint. So neither pleading aids them if this court determines that "loss causation" is an essential element of their claims.

(App. 43.)

Consistent therewith, Petitioners do not even ask this Court to decide the question of whether their pleadings alleged "loss causation". To the contrary, the questions presented for review are limited to two *general* questions which assume that loss causation has not been alleged, and tender to this Court the issue of whether such allegations are required. Thus, the issue of whether Petitioners alleged "loss causation" in the Complaint or the Amended Complaint is not before this Court, and Petitioners' vague arguments with respect thereto should be ignored.[3]

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[2] Indeed, even if the so-called "facts" relating to "competence" had been alleged, Petitioners still did not allege that the so-called "incompetence" caused their loss.

[3] Petitioners' failure to attach their pleadings to their Petition further confirms that they raise no issue as to the interpretation of these pleadings.

## REASONS FOR DENYING THE PETITION

### I.

### The Circuits Faced With The Issue Of Causation In Rule 10b-5 Cases Have Uniformly Required An Allegation Of "Loss Causation" Or Its Equivalent

#### A. "Loss Causation" Or Its Equivalent Is Not A Novel Concept—It Is Deeply Rooted In The Law

The requirement of proximate or "loss" causation is hardly a novel or revolutionary development in the law. As the Seventh Circuit emphasized below, the concept of loss causation (or its equivalent) is firmly rooted in basic common law:

> Indeed what securities lawyers call "loss causation" is the standard common law fraud rule, merely borrowed for use in federal securities fraud cases. It is more fundamental still; it is an instance of the common law's universal requirement that the tort plaintiff prove causation. . . . No hurt, no tort.

*Bastian v. Petren Resources Corp.*, 892 F.2d 680, 683-84 (7th Cir. 1990). (Citations omitted.)

The application of "loss causation" to the purchase and sale of securities cases is basic:

> [I]f false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors [which] in no way relate to the representations will not afford any basis for recovery. It is only where the fact misstated was of a nature calculated to bring about such a result that damages for it can be recovered.

W. P. Keeton, Prosser and Keeton On The Law of Torts §110 at 767 (5th Ed. 1984) (footnotes omitted). Likewise:

> [T]here is no liability when the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition. There is, for example, no liability when the shares go down because of the sudden death of the corporation's leading officers. *Although the misrepresentation has in fact caused the loss, since it has induced the purchase without which the loss would not have occurred, it is not a legal cause of the loss for which the maker is responsible.*

Restatement (Second) of Torts § 548A(b) at 107 (1977) (emphasis added).

The concept as applied to Rule 10b-5 was explained in *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983):

> Causation is related to but distinct from reliance. Reliance is a *causa sine qua non*, a type of "but for" requirement: had the investor known the truth he would not have acted. *Causation requires one further step in the analysis*: even if the investor would not otherwise have acted, was the misrepresented fact a proximate cause of the loss? . . . . *The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss* . . . . If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule [10b-5] is not permitted . . . .

(Emphasis added; citations omitted.)

Phrases such as "loss", "direct" and "proximate" cause are used as shorthand terms to convey the established

principle that a defendant's conduct must be substantially connected not only to the plaintiff's decision to buy a security but also to the events that actually result in the plaintiff's economic harm. More recently, the term "loss causation" has been used. Whatever term is employed, however, the concept is the same.[4]

**B. There Is No Conflict Among The Circuits On The Issue Of "Loss Causation" In Rule 10b-5 Claims[5]**

Causation is not and never has been a simple, formulaic principle, and a term such as "loss causation" cannot serve as a substitute for analysis or judgment. *See LHLC Corp. v. Cluett Peabody & Co., Inc.*, 842 F.2d 928, 931 (7th Cir. 1988), *cert. denied*, 109 S.Ct. 311 (1988). However, the fact that causation principles have to be applied carefully does not mean there is no consensus on how they should be applied or what their purpose should be.

On the contrary, loss causation is an accepted and governing principle in *every* circuit that has considered this issue in the last fifteen years (*i.e.*, the Second, Third, Fifth, Sixth, Seventh, Eighth, Ninth, Eleventh and D.C. Circuits), beginning with the Second Circuit in *Schlick v. Penn-Dixie Cement Corporation*, 507 F.2d 374 (2nd Cir. 1974), *cert. denied*, 421 U.S. 976 (1975). *E.g.* (listed by circuits), *Bennett v. United States Trust Co. of New York*, 770 F.2d 308, 313 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986); *Sims v. Faestel*, 638 F. Supp. 1281, 1283 (E.D.

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4 Even the nomenclature of "loss causation" is hardly new in the Rule 10b-5 arena. It has been used and applied in federal securities law cases since at least 1974. See *Schlick v. Penn-Dixie Cement Corporation*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 42 U.S. 976 (1975).

5 Petitioners do not even assert that there is a split in the circuits on the issue of the causation element under RICO. Accordingly, that argument is waived by Petitioners and will not be addressed in this Response.

Pa. 1986), *aff'd* 813 F.2d 399 (3rd Cir. 1987); *Nutis v. Penn Merchandising Corp.*, 610 F. Supp. 1573, 1580-81 (E.D. Pa. 1985), *aff'd*, 791 F.2d 919 (3d Cir. 1986); *Huddleston v. Herman & MacLean*, 640 F.2d at 549; *Platsis v. E.F. Hutton & Co., Inc.*, 642 F. Supp. 1277, 1299-1300 (W.D. Mich. 1986), *aff'd*, 829 F.2d 13 (6th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988); *Bastian v. Petren Resources Corp.*, 892 F.2d at 683-84; *Harris v. Union Electric Co.*, 787 F.2d 355, 367 (8th Cir. 1986), *cert. denied*, 479 U.S. 823 (1986); *In re Financial Corp. of America Shareholder Litigation*, 796 F.2d 1126, 1130 (9th Cir. 1986); *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988); *see Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35 n.5 (D.C. Cir. 1987). Petitioners have not cited even one case which has rejected the "loss causation" requirement.

Petitioners' assertion that the Seventh Circuit recognized a split among the circuits is disingenuous. (Petition, p. 21.) The Seventh Circuit did no such thing. To the contrary, that court expressly stated that the cases "greatly preponderate" in favor of loss causation and that any conflict that there may be is within rather than among circuits. *Bastian v. Petren Resources Corp.*, 892 F.2d at 685.

Each circuit in which Petitioners assert there is a so-called conflict will be addressed below. The analysis shows that what Petitioners mistakenly label "confusion and conflict" is nothing more than the application of the causation principle to the *facts* of individual cases. Far from "undercutting" the "loss causation" requirement, these cases strengthen the principle by applying it consistently.

**1. The Seventh Circuit**

The Seventh Circuit has uniformly required "loss causation"—or its equivalent—in Rule 10b-5 actions. It is true that the phrase "loss causation" was criticized by the

Seventh Circuit as a poor choice of *words* on the ground that it is "ungainly" and can sometimes "hinder rather than facilitate understanding." *LHLC Corp. v. Cluett Peabody & Co., Inc.*, 842 F.2d at 931. However, the court did not criticize the *concept*. Rather, the court expressly held that "loss causation" is a necessary element of a Rule 10b-5 action:

> Ever since *Schlick v. Penn-Dixie Cement Corp.*, courts have been distinguishing between 'transaction causation' and 'loss causation'. . . . The plaintiff *must show both.*

*Id.* at 931 (citations omitted) (emphasis added). In *LHLC*, the court defined "loss causation" as meaning that an investor cannot recover unless he or she can allege (and then prove) that "the investor would not have suffered a loss if the facts were what he believed them to be". *Id.*

Petitioners incorrectly suggest that in *LHLC* the Seventh Circuit rejected the "loss causation" analysis in favor of the analysis Petitioners advocate. Specifically, Petitioners assert that:

> The Court [sic] explained that when analyzing causation under the securities laws the focus should be on 'whether the information disclosed or withheld affected an investment decision.'

(Petition, p. 21.) However, Petitioners' argument is based on a quote from *LHLC* which is taken out of context in a misleading manner.

In *LHLC*, the plaintiff brought an action under Rule 10b-5 claiming that it had purchased the stock of the defendant's subsidiary at an artificially high price because the defendant had deliberately and materially misrepresented the value of its subsidiary's inventory. The defendant's accountant, Deloitte, Haskins & Sells ("Deloitte"), was also named as a defendant based upon a letter it had

written confirming that the inventory was worth the allegedly inflated amount. Deloitte's letter was written *after* plaintiff already had purchased the stock. After holding that *both* "transaction" and "loss" causation must be alleged, 842 F.2d at 931, the court analyzed whether "transaction" causation could be alleged where the alleged misrepresentation did not take place until after the purchase of the stock by plaintiff.

In analyzing the issue, the court focused on what "transaction" the transaction causation element referred to. Deloitte's letter arguably delayed plaintiff's discovery that the inventory's value was inflated and probably caused plaintiff to delay the filing of its lawsuit. The court noted that the filing of a lawsuit is a "transaction;" thus Deloitte's letter involved *some sort* of "transaction causation." However, the court stated:

> What should happen when the missing information affected a decision not to file a lawsuit about the securities . . . ?
>
> We have suggested in recent years that the appropriate inquiry is whether the information disclosed or withheld affected an *investment* decision . . . . Whether to . . . file a lawsuit is important, but the securities laws do not apply to [such decisions].

*LHLC Corp.*, 842 F.2d at 931. Thus, the language in *LHLC* on which Petitioners rely was explaining only what is meant by *transaction* causation and had nothing to do with "loss" causation. At no point did the court even suggest that "loss causation" or its equivalent was not required to sustain a Rule 10b-5 claim.

In *Rankow v. First Chicago Corp.*, 870 F.2d 356 (7th Cir. 1989), the Seventh Circuit reaffirmed these principles. In that case, the court found that the complaint *sufficiently* alleged "loss causation" and rejected the defendant's attempts to modify *LHLC*'s definition of that term. *Id.*

at 367. In no way did *Rankow* dispense with the loss causation requirement. The Seventh Circuit reaffirmed this principle in the case below. *Bastian*, 892 F.2d at 683-84. Thus, the Seventh Circuit cases are consistent in requiring loss causation.[6]

**2. The Second Circuit**

Petitioners are also incorrect in their assertion that the Second Circuit's position on "loss causation" is conflicting and confusing. The Second Circuit has consistently required plaintiffs to plead and prove "loss causation" in Rule 10b-5 actions. *E.g., Ryder Energy Distribution Corporation v. Merrill Lynch Commodities, Inc.*, 865 F.2d 492, 493 (2nd Cir. 1989); *Wilson v. Ruffa & Hanover*, 844 F.2d 81, 85-86 (2nd Cir. 1988); *Manufacturers Hanover Trust v. Drysdale Sec. Corp.*, 801 F.2d 13, 20-21 (2nd Cir. 1986), *cert. denied*, 479 U.S. 1066 (1987); *Bennett v. United States Trust Co. of New York*, 770 F.2d at 313; *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d at 380-381.

Petitioners nevertheless point to the 1980 case of *Marbury Management v. Kohn*, 629 F.2d 705 (2nd Cir. 1980), *cert. denied*, 449 U.S. 1011 (1980), as an exception which, they argue, creates a conflict within the Second Circuit. However, that case did not directly reject the loss causation requirement. (*Id.* at 708) Moreover, it has not de-

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[6] The concept that defendants should not be liable under Rule 10b-5 for losses caused by factors or forces not reasonably related to their alleged wrongdoing has long been an accepted principle of law in the Seventh Circuit, irrespective of the phrase "loss causation." *E.g., First Interstate Bank of Nevada v. Chapman & Cutler*, 837 F.2d 775, 779-80 (7th Cir. 1988) (intervening event breaks chain of causation); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1051 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977) (the malpractice of plaintiff's attorney was the superseding cause of plaintiff's damages, notwithstanding the fact that defendant violated Rule 10b-5).

tracted from the consistent application of loss causation in the Second Circuit. Instead, as even Petitioners recognize, *Marbury*'s majority opinion has been uniformly and repeatedly ignored in favor of its dissent. (Petition, p. 10.) Indeed, after *Marbury*, the Second Circuit has reaffirmed the loss causation principle in the series of cases cited above.

### 3. The Eleventh Circuit

The Eleventh Circuit has also adopted and consistently applied the loss causation principle to Rule 10b-5 claims. *Bruschi v. Brown*, 876 F.2d 1526, 1530 (11th Cir. 1989); *Rousseff v. E.F. Hutton Co., Inc.*, 843 F.2d 1326, 1329 (11th Cir. 1988).

Petitioners' contention that the Eleventh Circuit recognized an exception to the application of "loss causation" in *Bruschi* is incorrect. In *Bruschi*, the court expressly confirmed that "loss causation" was a requirement in Rule 10b-5 cases. As the court stated:

> . . . even though the defendant's misconduct induces the plaintiff to make the investment, if the particular loss complained of is caused by supervening general market forces or other factors unrelated to the defendant's misconduct that operate to reduce the value of the plaintiff's securities, the plaintiff is precluded from recovery under Rule 10b-5.

*Bruschi v. Brown*, 876 F.2d at 1530. The court then applied this principle to the facts of the case before it and found that the plaintiff had created an issue of fact as to whether the alleged misrepresentation related to the reason for the decline in the value of her investment. Thus, contrary to Petitioners' assertion, the Eleventh Circuit did not recognize an exception to "loss causation"; it simply found that the plaintiff had offered sufficient evidence of "loss causation" to defeat a motion for summary judgment. *Id.* at 1531.

**4. The Fifth Circuit**

Similarly, the Fifth Circuit has consistently and uniformly required loss causation or its equivalent in Rule 10b-5 actions. *E.g.*, *Huddleston v. Herman & MacLean*, 640 F.2d at 549.

Petitioners' characterization of *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), as a case that somehow runs counter to *Huddleston* and that "undercuts" the application of "loss causation" in the Fifth Circuit is disingenuous. In *Shores*, the Fifth Circuit expressly declined to decide the "loss causation" issue because it was not raised by either party. *Id.* at 469 (citing *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d at 384 (2d Cir. 1974)–Frankel, J. concurring–issue does not have to be addressed if not raised by the parties). Thus, *Shores* was a reliance case and the majority and dissenting opinions dealt with that issue only.

Furthermore, Judge Garza, a member of the *Shores* majority, later authored *Godchaux v. Conveying Techniques, Inc.*, 846 F.2d 306 (5th Cir. 1988), a case in which the Fifth Circuit reaffirmed *Huddleston* and its causation requirement in Rule 10b-5 cases. *Id.* at 319.

**5. The So-Called Exception To "Loss Causation"**

Petitioners' assertion that some courts have created an exception to the "loss causation" requirement where brokers, privities or fiduciaries are involved is a gross overstatement and irrelevant for purposes of this Petition. Indeed, none of the cases cited by Petitioners makes a general exception for brokers, privities or fiduciaries. Specifically, in *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767 (9th Cir. 1984), the Ninth Circuit applied a narrow exception to the "loss causation" requirement where the defendant broker was alleged to have *churned* a customer's account. *Id.* at 773. This exception was nar-

rowly limited to the facts of that case and can in no way be read to set forth a general exception governing cases involving fiduciaries, brokers or privities. Similarly, the other case on which Petitioners rely, *In re Letterman Bros. Energy Securities Litigation*, 799 F.2d 967 (5th Cir. 1986), does not support their assertion. Indeed, in that case, the Fifth Circuit affirmed the district court's directed verdict in favor of the defendants because the plaintiffs had failed to establish any damages. *Id.* at 972. Significantly, the court rejected the plaintiff's argument that they should have been awarded rescission damages and stated:

> To hold BancTexas liable under a rescissional standard 'would be to place on [it] the burden of any decline in the value of securities between the date of the purchase and the date of the sale even though only a portion of that decline may have been proximately caused by the defendants' wrong.'

*Id.* at 972-73 (citing *Huddleston*, 640 F.2d at 555.)

In all events, for purposes of this Petition, the exception for "churning cases" is irrelevant. Petitioners never alleged or argued below that Respondents were guilty of churning. Nor could they. Respondent McDermott is a law firm which allegedly assisted the sellers in drafting the offering memoranda; it was not a broker, seller or financial advisor. Accordingly, this so-called exception to the "loss causation" requirement has nothing whatsoever to do with this case and is not before this Court.

## II.

## "Loss Causation" Or Its Equivalent Should Continue To Be A Necessary Element Of A Rule 10b-5 Claim

### A. "Loss Causation" Or Its Equivalent Is Fair And Equitable, And Consistent With This Court's Prior Decisions And The Purposes Underlying The Federal Securities Laws

Petitioners ask this Court to overturn every circuit that has confronted the issue of "loss causation" and to simply

discard fifteen years of direct precedent, as well as one of the most fundamental building blocks of Anglo American Jurisprudence—causation. Yet, the so-called "policy" considerations that Petitioners' offer in support of such an extraordinary request cannot withstand the test of careful analysis. In a nutshell, Petitioners contend that:

> [no one] should be concerned with protecting the rights and liabilities of persons who have engaged in intentional fraud (Petition, p. 18)

and that

> there is no reason why [a defendant] should not be compelled to 'insure' that the victims of his fraud suffer no loss (Petition, p. 18).

Petitioners insist that if a person makes alleged misrepresentations or omissions in connection with the sale of stock, he or she thereafter should be held liable for all of the subsequent decline in the value of the stock, even if the allegedly misstated or omitted facts had nothing whatsoever to do with that decline.

Neither Section 10(b) nor Rule 10b-5 expressly provides for the type of *per se* civil liability which the Petitioners are proposing. Thus, any such liability must be implied. In determining whether such rights can be implied, the role of the courts "is limited solely to determining whether Congress intended to create the private right of action asserted by [the plaintiff]." *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979). To carry out this function, the courts are required primarily to rely upon the language of the statute in question and its legislative history. *Id.* Here, Petitioners have pointed to no particular language in Section 10(b) or Rule 10b-5 and to no legislative history which supports the concept that Congress intended defendants to be held liable as *insurers*. The absence of these factors strongly weighs against the implication of the rights and liabilities which Petitioners are proposing.

The only support that Petitioners offer for the adoption of liability without proof of causation is their contention that requiring causation would eviscerate the deterrent effect of the securities laws. (Petition, p. 12.) However, this contention is unfounded. First, a prospective wrongdoer does not know whether his or her fraud will directly cause the potential harm and, thus, must fear liability under Rule 10b-5 even if loss causation is required.

Moreover, Section 10(b) of the 1934 Act is not the only section of the securities laws which addresses fraud in connection with the sale of securities. Other sections of the securities laws, which are aimed at the same conduct, do not require causation. Thus, even assuming that requiring loss causation in Rule 10b-5 actions somehow ameliorates the deterrent effect of the securities laws, these other sections provide sufficient deterrence. For example, Section 12 of the 1933 Act provides that a person who offers or sells a security based upon material misrepresentations or omissions is liable to the purchaser for the consideration paid for the security or for damages if the purchaser no longer owns the security. Section 12 does not require "loss causation". Because a prospective wrongdoer must assume that he or she may be sued under Section 12 without *any* causation requirement, the deterrence objective is met.

In addition, the relevant policy considerations counsel retaining causation as a requirement in Rule 10b-5 claims. When investments are made, the investors assume certain risks, including the risk that unexpected economic events or the unpredictable play of market conditions could destroy the value of their investments. Nowhere is this more clear than in cases like the one at bar where an inherently high-risk investment in oil and gas drilling is at issue. If unexpected economic events do occur, it is only fair that the investor absorb the losses resulting from the risks he assumed just as the investor would fully

benefit from any gains. *See, e.g., Platsis v. E.F. Hutton & Co., Inc.*, 642 F. Supp. at 1299-1300.

This conclusion should not be changed because the investor later discovers that there was a securities law violation in connection with the original purchase—if that violation was unrelated to the economic events that caused the loss. Under such circumstances, regardless of the fraud, the loss results from exactly the risks the investor knowingly assumed and took into consideration when he or she weighed the economic risks and benefits of the investment.[7]

By the same token, requiring that the investor absorb losses resulting from risks he or she agreed to assume is not overly protective of the alleged wrongdoer. Under the "loss causation" concept, if an alleged violation was in fact the reason for the decline in the value of the securities, the alleged wrongdoer *is fully* responsible for the loss under Rule 10b-5 and otherwise. Furthermore, even if the alleged securities law violation did not actually cause the loss, the alleged wrongdoer is still liable for rescission under Section 12.

Based on the above, it is evident that Congress struck a proper and just balance in the federal securities laws. Liabilities to deter and compensate for fraud are present; at the same time, investors continue to be subject to the economic risks they knowingly agreed to assume.

The radical change in the law for which Petitioners are lobbying would result in the courts creating a penalty to be imposed in Rule 10b-5 cases. This would be inappropriate for at least two reasons. First, if such a penalty

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[7] Even Petitioners recognize, as they must, that "[a] defendant should not be compelled to bear the consequences of a risk which the investor would otherwise have accepted." (Petition, p. 19.)

is to be created, it should be created by Congress, not this Court. Second, such a penalty would make the promoter an insurer against all of the natural and ordinary risks which the investors knowingly undertook. That would be unfair, even to promoters who have committed a securities law violation. After all, notwithstanding Plaintiffs' irresponsible arguments to the contrary, such persons do continue to have rights deserving of protection under the law.[8] Although a defendant should be held fully accountable for all harm proximately caused by his or her wrongdoing, penalties should not arbitrarily be imposed on a defendant for losses caused by independent factors unrelated to his or her alleged wrongful conduct. As the courts have held:

> To find causation despite an intervening causative factor would transform the perpetrator of the fraud into 'an insurer of the investment, responsible for an indefinite period of time for any and all manner of unforeseen difficulties which may eventually beset the stock.'

*In re Catanella and E.F. Hutton and Securities Litigation*, 583 F. Supp. 1388, 1417 (E.D. Pa. 1984); *see Huddleston v. Herman & MacLean*, 640 F.2d at 549.

Perhaps two hypotheticals will even more clearly serve to illustrate the point.

**Hypothetical Number 1**

The plaintiff was solicited to invest in an oil and gas venture, the sole purpose of which was to develop the Smith Well. At the time of plaintiff's investment the seller knew that the Smith Well was a dry hole, but did not

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[8] For example, if a violation has caused no injury, there can be no Rule 10b-5 claim—even as against a defendant who has made a fraudulent misrepresentation. *Harris Trust and Savings Bank v. Ellis*, 810 F.2d 700, 706 (7th Cir. 1987).

disclose that fact. In such a case there is "transaction causation." Had the investor known the Well was dry at the time of the investment, the purchase would never have been made. In addition, there is "loss causation." The reason the investment was worthless was that the Well was dry—the very fact not disclosed. In this hypothetical, the investor can allege both "transaction" and "loss" causation. Obviously, the investor has a valid claim under Rule 10b-5.

**Hypothetical Number 2**

As in hypothetical number 1, the plaintiff was solicited to invest in an oil and gas venture, the sole purpose of which was to develop the Smith Well. Again, the Smith Well turned out to be a dry hole. However, in this hypothetical the seller did not know that the Well was dry at the time the investment was sold to the plaintiff. On the contrary, the seller then believed the Well was going to be a gas-producing well. Nevertheless, the Well later turned out to be dry. As a result, the plaintiff's investment became worthless.

In connection with the sale to the plaintiff, the seller had failed to disclose that the drilling equipment to be used in the venture was not insured. Fortunately, however, the equipment was never damaged. After the Well turned out to be dry and the investment worthless, the plaintiff discovered the seller's omission as to the insurance, and sued under Rule 10b-5. The plaintiff alleged that he never would have invested had he known that the equipment was not insured and, if he had not invested, he never would have suffered the loss caused by the later discovery that the Well was dry. The investor did not allege—nor could he—that the omitted fact concerning the lack of insurance caused the investment to become worthless.

In this hypothetical the investor has adequately alleged "transaction causation"—he alleged that "but for" the omission as to the insurance he never would have invested. However, he did not allege "loss causation" because the particular fact omitted had nothing to do with the ultimate decline in the value of the investment. Even though there was an omission, and one on which the investor based his investment decision, the omission had nothing whatsoever to do with the decline in the value of the investment. Even "if the facts were what [the investor] believed them to be"[9]—*i.e.*, even if the equipment had been insured—the investor still would have suffered the loss.

Does this investor have a claim under Rule 10b-5? Should he be able to sue because his investment became worthless due to no fault of the seller? Isn't the risk that the Well would turn out to be dry exactly the risk every investor assumes in an oil and gas venture? Should the seller retroactively be transformed into a guarantor or insurer that the Well would not be dry just because the absence of insurance was not disclosed? The answer is no.

The so-called "neutral principle" being urged by Petitioners can be further tested by adding additional facts to hypothetical no. 2.[10] Assume that, after the investment in hypothetical no. 2 had been made, the seller got the insurance which he had represented had already been obtained? Even though that would have "cured" the misrepresentation, there would presumably be no effect on "transaction causation"—the plaintiff still would not have invested had he known the equipment was *then* uninsured.

[9] *See LHLC*, 842 F.2d at 931.

[10] We do not suggest that these additional facts are present in the instant case. They are offered solely to test the principles at issue herein.

Yet, under the "neutral principle" urged by Plaintiffs, the investor would have a claim under Rule 10b-5. Such a "principle" should not become the law.

Likewise, suppose that the Smith Well had initially been very productive and the value of the securities had increased greatly so that the investors could have sold at a profit several years after their investment. However, still later the Well dried up and the value of the securities ultimately declined to zero. Suppose further that the sellers never purchased the insurance but that the lack of insurance did not cause the value of the securities to decline. Again, the intervening increase in value would presumably have no effect on "transaction causation"—the investors originally would not have purchased had they known that the equipment was not insured. But should those investors who did not sell at a profit, but who continued to make the investment decision to hold their securities, have a claim under Rule 10b-5 because, ultimately, the securities became worthless? Under the "neutral principle" urged by Petitioners, Petitioners would say there is a claim because *but for* the insurance misrepresentation they never would have invested.

As these hypotheticals illustrate, the radical shift in the law urged by Petitioners does not pass scrutiny. Should this Court adopt such a revolutionary proposition, it would undermine the well-established and uniform case law concerning the scope of the federal securities laws as well as basic concepts of logic and fairness that have always been at the foundation of tort law. Any such change in these principles as they apply to the federal securities laws should come, if at all, from Congress, not this Court.

Nor do the cases previously decided by this Court and cited by Petitioners alter this conclusion. Those cases are easily distinguished because they either do not address

the issue of causation, do not concern Rule 10b-5, or, when properly read, contradict Petitioners' position.

Petitioners cite *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) for the proposition that common law principles are inappropriate for federal securities law cases. *Capital Gains* made no such holding. On the contrary, this Court applied common law principles in that case; the Court merely held that, over time, the common law principles had changed. *Id.* at 193.

Petitioners also cite *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). The *Basic* case focused on the doctrine of "reliance" and "transaction causation," the only issue presented in that case. That case did not discuss loss causation in any way. Accordingly, *Basic* is inapposite and lends no support to Petitioners' position.

*Mills v. Electric Auto-Lite*, 396 U.S. 375 (1970) also does not help Petitioners. In *Mills*, material misrepresentations were made in a proxy statement and the proxies thereafter were voted with respect to a corporate merger which was approved. The Court held that the misrepresentations were actionable under Section 14(a) of the Securities Exchange Act of 1934, and remanded the case for a determination of the appropriate remedy, if any. *Mills* did not concern Rule 10b-5. Furthermore, by remanding the case for a determination of the proper remedy, this Court in effect required consideration of the harm actually caused by the proxy misrepresentations in fashioning the appropriate relief. Significantly, the Court stated:

> . . . where, as here, the misleading aspect of the solicitation did not relate to the terms of the merger, monetary relief might be afforded to the shareholders only if the merger resulted in a reduction of the earnings or earnings potential of their holdings. In short, damages should be recoverable only to the extent that they can be shown.

*Id.* at 388-89. Significantly, after remand, the Seventh Circuit affirmed the dismissal of the *Mills* case on the ground that the misrepresentation had caused no harm. *Mills v. Electric Auto-Lite Company*, 552 F.2d 1239, 1249 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977).

*Affiliated Ute v. United States*, 406 U.S. 128 (1972) also does not support Petitioners' position. In *Affiliated Ute*, a group of Indians formed a corporation to hold and manage tribal assets. Stock of the corporation was issued to tribal members. The tribe designated a local bank as a transfer agent for the corporation's stock.

The bank agreed that it "would be acting for the individual [Indian] stockholders." *Id.* at 152. As a result, the Indians relied on the bank to inform them of the market value of their shares, which some of the Indians would sell from time to time. Despite this, two officers of the bank secretly created a market in the stock among non-Indians. The bankers periodically induced the Indians to sell their stock to them and the bankers then sold the stock for a much higher price on the secret market the bankers had created. In addition, the bankers induced the Indians to sell their stock to non-Indians at a price below market and secretly took a commission from the non-Indians for arranging these transactions. The bankers did not disclose to the Indians either that they were market makers in the stock or that they were profiting from the stock transactions.

This Court upheld the Indians' claim that the bank officers had defrauded them in violation of Rule 10b-5. In its opinion, the Court dealt with the question of what was necessary for the sellers to prove *reliance* on the omitted facts in making their decision to sell. The Court held that positive proof of such reliance was not necessary; all that was needed was to show that a reasonable seller might

have considered the non-disclosed facts important in making the decision to sell. *Id.* at 153.

From this, Petitioners argue that this Court eliminated any requirement for "proximate" or "loss" causation. This principle of law is not stated in *Affiliated Ute*, nor can it be derived from the language or the facts of that case. The issue of "loss causation" was not raised in *Affiliated Ute* and, accordingly, this Court was not called upon to address that issue.

Moreover, in *Affiliated Ute*, the fact that the omission actually caused the plaintiffs' monetary loss was obvious and unquestioned and the Court's decision is in no way contrary to the "loss causation" principle. The omitted facts were linked to the Indians' economic losses in a direct and meaningful way. The Indians were led to believe that they were being paid the market price for their stock when in fact the bank officers were secretly paying them less than market price and making a profit for themselves. In short, "if the facts were what [the investors] believed them to be" *i.e.*, if the price was the true market price, they would not have suffered a loss. Thus, there was "loss causation." *LHLC*, 842 F.2d at 931.

Consequently, *Affiliated Ute* has been consistently cited as a *reliance* case, not as a case establishing an all-encompassing standard for causation. *E.g.*, *Huddleston*, 640 F.2d at 547-48; *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d at 381 (citing *Affiliated Ute* for the proposition that a plaintiff need not show actual reliance for "transaction causation," but still requiring "loss causation" as a separate element.) Correctly read, *Affiliated Ute* does not in any way relax or detract from the requirement that a plaintiff in a Rule 10b-5 case must plead and prove "proximate" or "loss" causation.

Finally, Petitioners rely on *dicta* in *Randall v. Loftsgaarden*, 478 U.S. 647 (1986). However, that case does

not support Plaintiffs' position. *Randall* involved the sole question of whether an investor's damages under Section 12(2) and Rule 10b-5 are to be reduced by the value of tax benefits received by the investor from the investment. That issue is not presented in this case. Moreover, the Court's resolution, if anything, supports Defendants' position. This Court held that no such credit is to be given, relying on a number of reasons. Two of the reasons related to technical tax issues and are of no moment here. However, the third reason was the Court's conclusion that, under *common law principles*, tax benefits are not to be credited against damages in fraud cases. *Id.* at 658-59. Thus, this Court applied common law principles to the federal securities laws. *Randall*'s further observation that Congress expressly allowed for recovery under Section 12(2), notwithstanding that the decline in value was not actually caused by the misrepresentations, is irrelevant here—this case does not arise under Section 12(2). *See Harris Trust and Savings Bank v. Ellis*, 810 F.2d 706.

Of particular interest in *Randall* is the passage in which this Court states:

> We may therefore infer that Congress chose a rescissory remedy when it enacted § 12(2) in order to deter prospectus fraud and encourage full disclosure as well as to make investors whole. Indeed, by enabling the victim of prospectus fraud to demand rescission upon tender of the security, *Congress shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud.*

*Randall v. Loftsgaarden*, 478 U.S. at 659 (emphasis added). This passage demonstrates that the risk of a decline in the value of an investment is ordinarily on the investor if the alleged fraud did not cause that decline. But, in Section 12(2), Congress expressly shifted the risk of such a loss to the seller of the security by allowing rescission upon

tender of the security. Significantly, Congress chose not to provide for any such shifting of risk in Section 10(b).

Finally, Petitioners' reliance on the Court's *dicta* in *Randall* that there is an open question as to whether rescission may be an appropriate *remedy* in Rule 10b-5 cases is inapposite for several reasons. First, rescission is a *measure* of damages which is relevant only *after* liability is determined. It is not a new standard for determining whether liability exists, nor a substitute for a necessary element of the underlying cause of action. In *Randall*, liability had already been determined before this Court addressed the rescission question. Likewise, in each of the cases cited by the Court in support of the proposition that the issue of rescission is an open question, the lower courts found liability first—then addressed the question of whether rescission was a proper remedy.

Moreover, even if rescission were otherwise available, it is irrelevant to Respondent McDermott, Will and Emery ("McDermott"). McDermott was not alleged to be the seller of the securities or otherwise in privity with Petitioners. McDermott was alleged simply to be the law firm for the sellers. Thus, there is nothing to rescind. Petitioners could not "return" the securities to McDermott and McDermott did not receive any of the purchase price to return to the Petitioners. *See Huddleston v. Herman & MacLean*, 640 F.2d at 555 (defendants cannot return the purchase price paid or rescind a transaction to which they were not a party).

For the same reason, Petitioners' related argument that they are entitled to recover "ill-gotten profits" also fails, at least as to McDermott. Even if there is such a principle (which is denied), Petitioners do not allege that McDermott made *any* profit on the sale of the securities to the Petitioners or anyone else, let alone "ill-gotten" profits.

**B. "Loss Causation" Should Not Be Exempted From The Requirement Of Pre-Filing Investigations**

Petitioners' contention that the Court should not require an allegation of "loss causation" because "it is often difficult for investors to make a pre-filing determination concerning the actual cause of the decline in their investments" deserves short shrift. In essence, Petitioners' claim that they should be excused from alleging an element of their claim so that they can initiate discovery to determine *if* they have such a claim. However, this is expressly prohibited by Rule 11 of the Federal Rules of Civil Procedure ("Rule 11") and the general rule that a plaintiff cannot file a claim without any basis solely to embark on a fishing expedition through discovery.

It is just this type of abuse that Rule 11 and the general pleading requirements are intended to prohibit. A party cannot make a claim unless it has a reasonable basis for believing that the claim is legitimate. This well founded rule should not be eviscerated by simply excusing a plaintiff from alleging an element of a claim. Indeed, taking Petitioners' argument to the logical extreme, this Court would be required to allow any plaintiff who can identify a wrong but cannot identify whether the wrong caused an injury to omit an allegation of causation and to proceed with discovery to determine whether there was causation. This Court should not put its imprimatur on such a result.

Similarly, Petitioners' suggestion that the burden of proving causation be shifted to defendants proves too much. If Petitioners' analysis is accepted, the same rationale would allow the shifting of this burden in all cases in which a plaintiff can identify wrongful conduct but does not know if it caused any harm. As in any cause of action, it is incumbent on the plaintiff to allege and prove that his or her harm was caused by the defendant; it is not the defen-

dant's burden to prove otherwise. Accordingly, "loss causation", like any element of a claim, must be alleged and proved in 10b-5 claims.

## III.

## Proximate Causation Or Its Equivalent Should Continue To Be A Necessary Element Of A RICO Claim

Section 1964(c) of RICO provides that a plaintiff has standing to sue for damages only if that person has been injured "by reason of" a defendant's violation of Section 1962. In *Haroco, Inc. v. American National Bank and Trust Co.*, 747 F.2d 384, 398 (7th Cir. 1984), *aff'd*, 473 U.S. 606 (1985), the Seventh Circuit held that this provision requires a showing of proximate cause:

> As we read this "by reason of" language, it simply imposes a *proximate cause* requirement on plaintiffs. (Emphasis added.)

*Haroco* was affirmed by this Court. Moreover, *Haroco*'s causation principle was stated again in the companion case of *Sedima, S/P.R.L. v. Imrex Co.*, 473 U.S. 479 (1985). In *Sedima*, the Court held:

> Conducting an enterprise that affects interstate commerce is obviously not in itself a violation of Section 1962, nor is mere commission of the predicate offenses. In addition, the plaintiff only has standing if, and can only recover to the extent that, he has been injured in his business or property *by the conduct constituting the violation.*
>
> * * *
>
> . . . the compensable injury necessarily is the harm *caused* by predicate acts . . .

*Id.* at 496, 497 (Emphasis added). Thus, to state a valid RICO claim, a plaintiff must allege that his or her injury was proximately caused by the defendant's commission of the predicate acts that constitute the RICO violation.

Petitioners nevertheless argue that *Sedima* supports their position that "proximate" or "loss" causation is not required, relying in great part on the *Sedima* Court's refusal to adopt a "racketeering injury" requirement in RICO cases because it would place requirements on questions relating to "standing" and "proximate cause" that were not intended by Congress. See *Sedima v. Imrex*, 473 U.S. at 498-99.

However, the discussion on which Petitioners rely offers no support to Petitioners' argument. This discussion from *Sedima* related only to the issue of whether a special "racketeering injury" similar to the type of "competitive injury" required under the anti-trust laws needed to be shown to recover under RICO, which the Court held did not. Thus, the "strict requirements on . . . 'proximate cause' " related only to the proposed, but rejected, requirement of "racketeering injury," not "proximate cause" generally. *Brandenburg v. Seidel*, 859 F.2d 1179, 1189 n.11 (4th Cir. 1988); *see also Sedima, S/P.R.L. v. Imrex Co.*, 473 U.S. at 497 n. 15.

Thus, it was a "RICO injury" requirement that this Court rejected in *Sedima*, not the requirement that a RICO plaintiff plead and prove that the predicate acts proximately caused his or her injury. As the Third Circuit states:

> The *Sedima* opinion makes plain that the injury which confers standing on a RICO plaintiff is injury flowing from commission of the predicate act, *not* injury flowing from the pattern of such acts.

*Town of Kearny v. Hudson Meadows Urban Removal Corp.*, 829 F.2d 1263, 1268 (3d Cir. 1987) (emphasis added).

Indeed, after *Sedima*, "proximate cause" has been consistently required under RICO. *See, e.g., Marshall & Ilsley Trust Co. v. Pate*, 819 F.2d 806, 809 (7th Cir. 1987) (a

plaintiff must prove "an injury directly resulting from some or all of the activities comprising the violation"); *Zervas v. Faulkner*, 861 F.2d 823, 833-34 (5th Cir. 1988) (proximate cause is required); *Brandenburg v. Seidel*, 859 F.2d at 1187-90; *Sperber v. Boesky*, 849 F.2d 60, 64 (2nd Cir. 1988); *Seawell v. Miller Brewing Co.*, 576 F. Supp. 424, 430 (M.D. N.C. 1983) (no proximate cause sufficient to maintain RICO claim where intervening event, not the alleged predicate acts, was the cause of loss).

Where, as here, the alleged predicate act is not the proximate cause of the injury, a plaintiff lacks standing to sue. *Nodine v. Textron, Inc.*, 819 F.2d 347, 348-49 (1st Cir. 1987); *Morast v. Lance*, 807 F.2d 926, 932-33 (11th Cir. 1987). Where the injury which a plaintiff complains of was not proximately caused by the predicate acts, he does not have standing as a RICO plaintiff.

Finally, it must be remembered that the only predicate acts relied on by Petitioners to support their RICO injury are the claimed Rule 10b-5 violations. Thus, if the Court upholds the dismissal of Petitioners' Rule 10b-5 claims, their RICO claims must fall, without more. There simply would not be any predicate acts on which to base the purported RICO claim. *See Brannan v. Eisenstein*, 804 F.2d 1041, 1046 (8th Cir. 1986); *First Pacific Bancorp, Inc. v. Bro*, 847 F.2d 542, 546 (9th Cir. 1988); *In re Catanella and E.F. Hutton Securities Litigation*, 583 F.Supp. at 1425 (E.D.Pa. 1984) (if securities claim fails for lack of loss causation, that claim cannot serve as a predicate offense under RICO); *In re Gas Reclamation, Inc. Securities Litigation*, 663 F. Supp. 1123 (S.D.N.Y. 1987) (where securities claim failed for lack of causation, RICO claim based on same alleged violations failed also). Respondents are unaware of any case which permits a plaintiff to sue under RICO for predicate acts where, as here, *no one* has a direct cause of action for the predicate acts them-

selves. Indeed, there would be no justification for allowing such a suit.[11]

## CONCLUSION

For the foregoing reasons, this Court should deny Petitioners' Petition for Certiorari.

Respectfully submitted,

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[11] We will not repeat all of the "policy" arguments set forth in Section 2 above; instead, they are incorporated by reference.

# APPENDIX

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 86 C 2006

R. RICHARD BASTIAN, III; B. P. LOUGHRIDGE, M.D.; RONALD D. ROTUNDA; MARCIA ROTUNDA; GENERAL SYNERGY INVESTMENTS, an Oklahoma partnership; GABRIEL FERNANDEZ; J. MAHAR; CMF ASSOCIATES, an Illinois partnership; ALFRED J. HENDRON, JR.; and M. T. DAVISSON,

Plaintiffs,

v.

PETREN RESOURCES CORPORATION, an Illinois corporation; FAESTEL INVESTMENTS, INC., an Illinois corporation; DAVID J. FAESTEL; MC DERMOTT, WILL & EMERY, a partnership; and BRIAN HUCKER,

Defendants.

## COMPLAINT

### *Introduction*

1. This is an action to rescind or recover damages resulting from plaintiffs' investments in two Illinois oil and gas limited partnerships known as Petren Oil and Gas Program 1981A ("Petren 1981A") and Petren Oil and Gas Program 1981B ("Petren 1981B").

### *Jurisdiction And Venue*

2. This Complaint arises under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. sec. 78a, *et seq.*,

under Section 17(a) of the Securities Act of 1933, 15 U.S.C. sec. 77a *et seq.*, and under Section 1962 of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. sec. 1961 *et seq.* Jurisdiction is conferred upon this Court by 28 U.S.C. sec. 1331, by Section 27 of the Exchange Act, 15 U.S.C. sec. 78aa, by Section 1964 of RICO, 18 U.S.C. sec. 1964, and by principles of pendent jurisdiction.

3. Venue within this District and Division is proper under 28 U.S.C. sec. 1391(b) and (c), under 15 U.S.C. sec. 78aa, and under 18 U.S.C. sec. 1965, in that all of the defendants have transacted their affairs and most of the unlawful acts and transactions alleged herein occurred in the Northern District of Illinois.

*The Parties*

4. Plaintiffs, R. Richard Bastian, III, B. P. Loughridge, M.D., Ronald D. Rotunda, Marcia Rotunda, General Synergy Investments, Gabriel Fernandez, J. Mahar, CFM Associates, Alfred J. Hendron, Jr., and M. T. Davisson, purchased limited partnership interests in one or more of the Petren Oil and Gas Programs.

5. Defendant, Petren Resourses Corporation ("Petren"), is an Illinois corporation which, at all times relevant hereto, maintained its principal place of business in Crystal Lake, Illinois. Petren is a co-general partner in both Petren Oil and Gas Programs.

6. Defendant, Faestel Investments, Inc. ("FII"), is an Illinois corporation which, at all times relevant hereto, maintained its principal place of business in Crystal Lake, Illinois. FII is a co-general partner in both Petren Oil and Gas Programs.

7. Defendant, David J. Faestel ("Faestel"), is an officer, director and sole shareholder of FII and the Chairman of the Board and principal shareholder of Petren.

8. Defendant, McDermott, Will & Emery ("MWE"), is an Illinois partnership which is engaged in the practice of law. MWE's principal office is located in Chicago, Illinois.

9. Defendant, Brian S. Hucker ("Hucker"), is an attorney and partner with MWE.

*Description Of Petren Oil And Gas Programs*

10. Petren 1981A and Petren 1981B were formed to explore and drill for oil and gas. Petren 1981A was formed in or about May, 1981, and Petren 1981B was formed in or about September 1981.

11. In order to raise the funds necessary to explore and drill for oil and gas, Petren, FII and Faestel sold limited partnership interests in Petren 1981A and Petren 1981B.

12. In connection with their sales and solicitation efforts, Petren, FII and Faestel employed Hucker and MWE to prepare an "Offering Memorandum" for each of the Petren 1981A and Petren 1981B limited partnerships.

13. The Offering Memoranda which Hucker and MWE prepared were distributed to each of the investors in the limited partnerships prior to the time they made their investments.

14. The Offering Memoranda which Hucker and MWE prepared are in excess of 95 pages in length and are substantially similar. The Offering Memoranda purport to disclose all material information about the limited partnerships, including material information about the two general partners and their principals.

15. Each Offering Memorandum identifies MWE as counsel for the partnership.

16. Each Offering Memorandum describes Faestel, FII and Petren as being qualified and experienced in oil and gas ventures.

17. Each of the plaintiffs received and reviewed a copy of the Offering Memorandum prior to making their investment in the Petren Oil and Gas Programs.

*Non-Disclosures In The Offering Memoranda*

18. Each Offering Memorandum failed to disclose the following facts about the qualifications and prior experience of Faestel, FII and Petren:

(a) That in or about September, 1979, Faestel and FII were sued in federal court in Chicago by investors in a previous oil and gas venture they had promoted and had been charged in that lawsuit with violating federal and state securities laws;

(b) That Faestel and FII had defaulted in the payment of approximately $1,000,000 in loans they had obtained from the Northern Trust Company in connection with prior oil and gas ventures they had promoted; and

(c) That Petren was established by Faestel and FII solely to promote the Petren Oil and Gas Programs and that Petren was, in actuality, nothing more than the alter ego of Faestel and FII.

19. Each of the foregoing facts were known by the defendants at the time the Offering Memoranda were prepared and distributed to investors. MWE and Hucker represented Faestel and FII in the securities litigation de-

scribed in paragraph 18(a) above, and, on information and belief, represented them in connection with the loans they obtained from the Northern Trust and in the formation of Petren.

20. Each of the facts described in paragraph 18 above were material and should have been disclosed in the Offering Memoranda which were distributed to investors, in order to make the Offering Memoranda not misleading.

21. After receiving and reviewing the Offering Memoranda, plaintiffs invested in one or more of the Petren Oil and Gas Programs as follows:

| *Name* | *Amount Invested* | *Program* |
|---|---|---|
| Ronald & Marcia Rotunda | $ 50,000 | Petren 1981B |
| B. P. Loughridge, M.D. | 100,000 | Petren 1981B |
| R. Richard Bastian, III | 50,000 | Petren 1981A |
| General Synergy Investments | 100,000 | Petren 1981B |
| Gabriel Fernandez | 25,000 | Petren 1981A |
| J. Mahar | 25,000 | Petren 1981A |
| CFM Associates | 100,000 | Petren 1981B |
| Alfred J. Hendron, Jr. | 25,000 | Petren 1981A |
| | 50,000 | Petren 1981B |
| M. T. Davisson | 25,000 | Petren 1981A |
| | 50,000 | Petren 1981B |
| Total Invested By Plaintiffs: | $600,000 | |

*Discovery Of The Non-Disclosures*

22. No plaintiff was aware of the facts described in paragraph 18 at the time they made their investments. Moreover, as a result of affirmative representations and statements contained in the Offering Memoranda, no plain-

tiff had any reason to suspect that the information contained in the Offering Memoranda was incomplete, misleading or otherwise untrue.

23. In late April, 1984, plaintiff Ronald B. Rotunda became concerned about his investment in Petren 1981B when he was informed by the general partners that the 1983 Petren 1981B financial statement would not be audited as had been represented in the Offering Memorandum. Rotunda's concern was further heightened when he contacted Hucker and other attorneys at MWE about the financial statement and was informed that MWE did not represent the Petren Oil and Gas partnerships but, rather, represented only the general partners.

24. Thereafter, Rotunda retained an attorney to investigate his investment. During the course of his investigation, Rotunda's attorney was told by Hucker that no other limited partners were questioning the conduct of Faestel or the general partners. Hucker's statement was not true and was made in order to lull Rotunda's attorney into a false sense of security. Contrary to Hucker's representations, at the time Rotunda's attorney was conducting his investigation, there were at least two separate federal actions filed against Faestel and the general partners relating to the Petren Oil and Gas Programs.

25. After learning of the pendency of the federal lawsuits against Faestel and the general partners, Rotunda's counsel, in or about September, 1984, conducted a search of court records in Cook County, Illinois, and discovered that Faestel and FII had been sued in 1979 for violations of the federal and state securities laws and that Northern Trust had filed suit against them on defaulted loans. This was the first time any of the plaintiffs had any knowledge that Faestel and FII had previously been sued

for securities laws violations or that, at the time they were promoting the Petren Oil and Gas Programs, they were in default on substantial loans.

26. By the time Rotunda's counsel discovered the non-disclosed facts described above, plaintiffs' investments in the Petren Oil and Gas Programs had become worthless.

## COUNT I

### ACTION FOR DEFENDANTS' VIOLATIONS OF SECTION 10(b) OF THE SECURITIES EXCHANGE ACT AND SEC RULE 10b-5

1. This action arises under Section 10(b) of the Securities Exchange Act, 15 U.S.C. sec. 78j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. sec. 240.10b-5.

2-27. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 2 through 27 of this Count I.

28. The Petren 1981A and Petren 1981B limited partnership interests which plaintiffs purchased are securities within the meaning of Section 3(a)(10) of the Securities Exchange Act, (15 U.S.C. sec. 78c(a)(10).

29. The Petren 1981A and Petren 1981B limited partnership interests which were sold to plaintiffs were sold through means and instrumentalities of interstate commerce.

30. The facts which defendants omitted to include in the Offering Memoranda were material, in that there is a substantial likelihood that plaintiffs would have considered them important in making their investment decision.

31. The omissions described above were made in connection with the sale to plaintiffs of limited partnership

interests in the Petren 1981A and Petren 1981B limited partnerships.

32. Each of the defendants had a duty to disclose the omitted facts. Alternatively, each defendant aided and abetted the other defendants in the breach of their duty to disclose the omitted facts.

33. In failing to disclose the omitted facts, or in aiding and abetting such non-disclosure, each defendant acted either with the intent to defraud or with recklessness.

34. By their failure, as described above, to disclose material facts, defendants violated Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Rescind plaintiffs' purchase of limited partnership interests in Petren 1981A and Petren 1981B and require defendants to refund the full amount of their investment plus interest from the date of the investment;

B. Alternatively, enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' unlawful conduct, along with prejudgment interest as the law may allow;

C. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys' fees; and

D. Grant plaintiffs such other, further and additional relief as the court may deem just and appropriate.

## COUNT II

### ACTION FOR DEFENDANTS' VIOLATIONS OF SECTION 17(a) OF THE SECURITIES ACT OF 1933

1. This action arises under Section 17(a) of the Securities Act of 1933, 15 U.S.C. sec. 77q(a).

2-27. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 2 through 27 of this Count II.

28. The Petren 1981A and Petren 1981B limited partnership interests which plaintiffs purchased are securities within the meaning of Section 2(1) of the Securities Act of 1933, 15 U.S.C. sec. 77b(1).

29-32. Plaintiffs incorporate and reallege the allegations of paragraphs 29 through 32 of Count I as paragraphs 29 through 32 of this Count II.

33. In failing to disclose the omitted facts, or in aiding and abetting such non-disclosure, each defendant acted either negligently, with the intent to defraud, or with recklessness.

34. By their failure, as described above, to disclose material facts, defendants violated Section 17(a) of the Securities Act of 1933, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Rescind plaintiffs' purchase of limited partnership interests in Petren 1981A and Petren 1981B and require defendants to refund the full amount of their investment plus interest from the date of the investment;

B. Alternatively, enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' unlawful conduct, along with prejudgment interest as the law may allow;

C. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys' fees; and

D. Grant plaintiffs such other, further and additional relief as the court may deem just and appropriate.

## COUNT III

### ACTION FOR DEFENDANTS' VIOLATIONS OF THE RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT

1. This action arises under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. sec. 1961, *et seq.* ("RICO").

2-27. Plaintiffs incorporate and reallege the allegations of paragraphs 1 through 26 of the Complaint as paragraphs 2 through 27 of this Count III.

28-34. Plaintiffs incorporate and reallege the allegations of paragraphs 28 through 34 of Count I, which describe defendants' violations of Section 10(b) and SEC Rule 10b-5, as paragraphs 28 through 34 of this Count III.

35-41. Plaintiffs incorporate and reallege the allegations of paragraphs 28 through 34 of Count II, which describe defendants' violations of Section 17(a) of the Securities Act of 1933, as paragraphs 35 through 41 of this Count III.

42. Petren 1981A and Petren 1981B are enterprises engaged in and whose activities affect interstate and foreign commerce.

43. Each defendant was employed by or associated with Petren 1981A and Petren 1981B at the time the acts complained of herein occurred.

44. Each defendant conducted and participated, either directly or indirectly, in the conduct of Petren 1981A's and Petren 1981B's affairs through a pattern of racketeering activity, in violation of 18 U.S.C. sec. 1962(c).

45. Each defendant combined, conspired and agreed to conduct the affairs of Petren 1981A and Petren 1981B through a pattern of racketeering activity in violation of 18 U.S.C. sec. 1962(d).

46. The pattern of racketeering activity through which the defendants conducted and participated in the affairs of Petren 1981A and Petren 1981B involved each of the following prohibited acts:

(a) Fraud in connection with the sale to plaintiffs of Petren 1981A limited partnership interests, in violation of Section 10(b) and SEC Rule 10b-5;

(b) Fraud in connection with the sale to plaintiffs of Petren 1981A limited partnership interests, in violation of Section 17(a) of the Securities Act of 1933;

(c) Fraud in connection with the sale to plaintiffs of Petren 1981B limited partnership interests, in violation of Section 10(b) and SEC Rule 10b-5; and

(d) Fraud in connection with the sale to plaintiffs of Petren 1981B limited partnership interests, in violation of Section 17(a) of the Securities Act of 1933.

47. All of the acts of racketeering activity hereinabove alleged occurred after the effective date of RICO and all occurred within ten years of a prior act.

48. Plaintiffs have been injured in their business and property by reason of the defendants' violations of 18 U.S.C. sec. 1962(c) and (d).

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for threefold the damages plaintiffs sustained as a result of defendants' violations of 18 U.S.C. sec. 1962(c) and (d);

B. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys fees; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

## COUNT IV

### ACTION FOR DEFENDANTS' VIOLATIONS OF THE ILLINOIS CONSUMER FRAUD AND DECEPTIVE PRACTICES ACT

1. This action arises under the Illinois Consumer Fraud and Deceptive Business Practices Act ("Illinois Consumer Fraud Act"), ILL. REV. STAT., ch. 121½, sec. 261, *et seq.*

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-28. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 3 through 28 of this Count IV.

29. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, defendants acted wilfully and wantonly and with the intent that plaintiffs and other investors rely upon the concealment or omission of such material facts.

30. By their failure, as described above, to disclose material facts in connection with the sale to plaintiffs of

limited partnership interests in Petren 1981A and Petren 1981B, defendants violated Section 2 of the Illinois Consumer Fraud Act, ILL. REV. STAT., ch. 121½, sec. 262, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' unlawful conduct, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys' fees; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

## COUNT V

### ACTION FOR BREACH OF DEFENDANTS' FIDUCIARY DUTIES

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-28. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 3 through 28 of this Count V.

29. By reason of their status as general partners of Petren 1981A and Petren 1981B, defendants Petren and FII stood in a fiduciary relationship to the limited partners and were obligated to deal fairly, openly and in good faith in connection with all partnership matters, including the sale to plaintiffs of limited partnership interests.

30. By reason of their status as counsel to Petren 1981A and Petren 1981B, Hucker and MWE stood in a fiduciary relationship to the limited partners and were obligated to deal fairly, openly and in good faith in connection with all partnership matters, including the sale to plaintiffs of limited partnership interests.

31. By reason of their failure to disclose material facts in connection with the sale of limited partnership interests, defendants Petren, FII, Hucker and MWE breached their fiduciary duties, causing damage to plaintiffs.

32. As a result of his actions and inactions, defendant Faestel participated in, and aided and abetted Petren, FII, Hucker and MWE in, the breach of their fiduciary duties to plaintiffs.

33. As a result of their actions and inactions, Hucker and MWE participated in, and aided and abetted Petren and FII in, the breach of their fiduciary duties to plaintiffs.

34. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, each defendant acted wilfully, wantonly and/or in reckless disregard of the rights and interests of plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a

result of defendants' breach of their fiduciary duties, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

## COUNT VI

### ACTION FOR COMMON LAW FRAUD

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the sum of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-28. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 3 through 28 of this Count VI.

29. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, each defendant acted wilfully, wantonly and/or in reckless disregard of the rights and interests of plaintiffs.

30. As a consequence of defendants' non-disclosure and omissions, plaintiffs were cheated and defrauded and were damaged thereby.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a

result of defendants' fraud, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

## COUNT VII

### ACTION FOR NEGLIGENCE AGAINST MWE AND HUCKER

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the sum of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-28. Plaintiffs incorporate and reallege paragraphs 1 through 26 of the Complaint as paragraphs 3 through 28 of this Count VII.

29. MWE and Hucker, as counsel for Petren 1981A and Petren 1981B, and as the attorneys responsible for the preparation of the Petren 1981A and Petren 1981B Offering Memoranda, had an affirmative duty to independently verify the disclosures made in the Offering Memoranda and ensure full disclosure of all material facts.

30. Plaintiffs were the intended or reasonably foreseeable beneficiaries of MWE's and Hucker's work product, and it was foreseeable that plaintiffs would rely upon the Offering Memoranda that MWE and Hucker prepared.

31. By failing to discover and/or disclose the material facts described above, defendants MWE and Hucker negligently failed to perform their duty to independently verify the disclosures made in the Offering Memoranda and to ensure full disclosure of all material facts, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants MWE and Hucker for the amount of damages sustained as a result of defendants' negligence, along with prejudgment interest as the law may allow;

B. Award plaintiffs, and order defendants to pay, the full cost of this action; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

R. RICHARD BASTIAN, III; B. P. LOUGHRIDGE, M.D.; RONALD D. ROTUNDA; MARCIA ROTUNDA; GENERAL SYNERGY INVESTMENTS, an Oklahoma partnership; GABRIEL FERNANDEZ; J. MAHAR; CMF ASSOCIATES, an Illinois partnership; ALFRED J. HENDRON, JR.; and M.T. DAVISSON

By: ______________________________

One of Their Attorneys

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Corrected Copy

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

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No. 86 C 2006
Hon. Brian Barnett Duff

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R. RICHARD BASTIAN, III; B. P. LOUGHRIDGE, M.D.; RONALD D. ROTUNDA; MARCIA ROTUNDA; GENERAL SYNERGY INVESTMENTS, an Oklahoma partnership; GABRIEL FERNANDEZ; J. MAHAR; CMF ASSOCIATES, an Illinois partnership; ALFRED J. HENDRON, JR.; and M. T. DAVISSON,

Plaintiffs,

v.

PETREN RESOURCES CORPORATION, an Illinois corporation; FAESTEL INVESTMENTS, INC., an Illinois corporation; DAVID J. FAESTEL, and MC DERMOTT, WILL & EMERY, a partnership,

Defendants.

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## AMENDED COMPLAINT

*Introduction*

1. This is an action to rescind or recover damages resulting from plaintiffs' investments in two Illinois oil and gas limited partnerships knows as Petren Oil and Gas Program 1981A ("Petren 1981A") and Petren Oil and Gas Program 1981B ("Petren 1981B"). Plaintiffs were fraudulently induced to make their investments and now seek to recover the full amount of their investment plus interest.

*Jurisdiction and Venue*

2. Jurisdiction is conferred upon this Court by 28 U.S.C. §1331, by §1964 of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §1964, and by principles of pendent jurisdiction.

3. Venue within this District and Division is proper under 28 U.S.C. §1391(b) and (c) and under 18 U.S.C. §1965, in that all of the defendants have transacted their affairs and most of the unlawful acts and transactions alleged herein occurred in the Northern District of Illinois.

*The Parties*

4. Plaintiffs R. Richard Bastian, III, B. P. Loughridge, M.D., Ronald D. Rotunda, Marcia Rotunda, General Synergy Investments, Gabriel Fernandez, J. Mahar, CMF Associates, Alfred J. Hendron, Jr. and M. T. Davisson each purchased limited partnership interests in one or more of the Petren Oil and Gas limited partnerships.

5. Defendant Petren Resources Corporation ("Petren") is an Illinois corporation which, at all times relevant hereto, maintained its principal place of business in Crystal Lake, Illinois. Petren is a co-general partner in both Petren Oil and Gas limited partnerships.

6. Defendant Faestel Investments, Inc. ("FII") is an Illinois corporation which, at all times relevant hereto, maintained its principal place of business in Crystal Lake, Illinois. FII is a co-general partner in both Petren Oil and Gas limited partnerships.

7. Defendant David J. Faestel ("Faestel") is an officer, director and sole shareholder of FII and the chairman and principal shareholder of Petren.

8. Defendant Mc Dermott, Will & Emery ("MWE") is an Illinois partnership which is engaged in the practice of law. MWE's principal office is located in Chicago, Illinois.

*Description of the Petren*
*Oil and Gas limited partnerships*

9. Petren 1981A and Petren 1981B limited partnerships were formed to explore and drill for oil and gas. Petren 1981A was formed in or about May, 1981, and Petren 1981B was formed in or about September, 1981.

10. In order to raise the funds necessary to explore and drill for oil and gas, Petren, FII and Faestel sold limited partnership interests in Petren 1981A and Petren 1981B.

11. In connection with their sales and solicitation efforts, Petren, FII and Faestel employed MWE to prepare an "Offering Memorandum" for each of the limited partnerships.

12. The Offering Memoranda which MWE prepared were distributed to each of the plaintiffs in the limited partnerships prior to the time they made their investments.

13. The Offering Memoranda which MWE prepared are each in excess of 95 pages in length and are substantially similar. The Offering Memoranda purport to disclose material information about the limited partnerships, including material information about the qualifications, experience and abilities of the two general partners and their principals.

14. Each Offering Memorandum identifies MWE as counsel for the partnership.

15. Each Offering Memorandum describes Faestel, FII and Petren as being qualified and experienced in oil and gas programs.

16. Each of the plaintiffs received and reviewed a copy of the Offering Memorandum prior to making their investment in the Petren Oil and Gas limited partnerships.

*Non-Disclosures In The Offering Memoranda*

17. Each Offering Memorandum failed to disclose the following facts about the qualifications and prior experience of Faestel, FII and Petren:

(a) That in or about September 4, 1979, Faestel and FII were sued in federal court in Chicago by investors in a previous oil and gas venture they had promoted and had been charged in that lawsuit with violating federal and state securities laws;

(b) That Faestel and FII had defaulted in the payment of approximately $1,000,000 in loans they had obtained from the Northern Trust Company in connection with prior ventures they had promoted; and

(c) That Petren was established by Faestel and FII solely to promote the Petren Oil and Gas limited partnerships and had no previous operating history or experience and an insubstantial net worth; and

(d) That Petren was, in actuality, nothing more than the alter ego of Faestel and FII.

18. Each of the foregoing facts were either known by the defendants at the time the Offering Memoranda were prepared and distributed to investors or, upon diligent inquiry, should have been known by the Defendants.

19. Each of the facts described in paragraph 18 above were material and should been disclosed in the Offering Memoranda which were distributed to investors in order to make the Offering Memoranda not misleading.

20. Had the facts described in paragraph 18 above been disclosed in the Offering Memoranda the limited partnership interests being offered would have been unmarketable.

21. After receiving and reviewing the Offering Memoranda, plaintiffs invested in one or more of the Petren Oil and Gas limited partnerships as follows:

| *Name* | *Amount Invested* | *Program* |
|---|---|---|
| Ronald & Marcia Rotunda | $ 50,000 | Petren 1981B |
| B. P. Loughridge, M.D. | 100,000 | Petren 1981B |
| R. Richard Bastian, III | 50,000 | Petren 1981A |
| General Synergy Investments | 100,000 | Petren 1981B |
| Gabriel Fernandez | 25,000 | Petren 1981A |
| J. Mahar | 25,000 | Petren 1981A |
| CFM Associates | 100,000 | Petren 1981B |
| Alfred J. Hendron, Jr. | 25,000 | Petren 1981A |
| | 50,000 | Petren 1981B |
| M. T. Davisson | 25,000 | Petren 1981A |
| | 50,000 | Petren 1981B |
| Total Invested By Plaintiffs: | $600,000 | |

22. Had the facts described in paragraph 18 above been disclosed in the Offering Memoranda distributed to the Plaintiffs, none of the plaintiffs would have invested any money in either Petren limited partnership.

23. No plaintiff was aware of the facts described in paragraph 18 at the time they made their investments.

Moreover, as a result of affirmative representations and statements contained in the Offering Memoranda, no plaintiff had any reason to suspect that the information contained in the Offering Memoranda was incomplete, misleading or otherwise untrue.

24. In late April, 1984, plaintiff Ronald B. Rutunda became concerned about his investment in Petren 1981B when he was informed by the general partners that the 1983 Petren 1981B financial statement would not be audited as had been represented in the Offering Memorandum. Rotunda's concern was further heightened when he contacted Brian Hucker ("Hucker"), a partner at MWE, about the financial statement and was informed that, contrary to statements made in the Offering Memoranda, MWE did not represent the Petren Oil and Gas partnerships but, rather, represented only the general partners.

25. Thereafter, Rotunda retained an attorney to investigate his investment. During the course of this investigation, Rotunda's attorney was told by Hucker that no other limited partners were questioning the conduct of Faestel or the general partners. Hucker's statement was not true and was made in order to lull Rotunda's attorney into a false sense of security. Contrary to Hucker's representations, at the time Rotunda's attorney was conducting his investigation, there were at least two separate federal actions filed against Faestel and the general partners relating the Petren Oil and Gas limited partnerships.

26. After learning of the pendency of the federal lawsuits against Faestel and the general partners, Rotunda's counsel, in or about September, 1984, conducted a search of court records in Cook County, Illinois, and discovered that Faestel and FII had been sued in 1979 for violations of the federal and state securities laws and that North-

ern Trust had filed suit against them on the defaulted loans. This was the first time any of the plaintiffs had any knowledge that Faestel and FII had previously been sued for securities laws violations or that, at the time they were promoting the Petren Oil and Gas Programs, they were in default on substantial loans.

27. By the time Rotunda's counsel discoverd the non-disclosed facts described above, plaintiff's investments in the Petren Oil and Gas limited partnerships had become worthless.

## COUNT I

### ACTION FOR VIOLATIONS OF SECTION 1962(C) OF THE RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT

1-27. Plaintiffs incorporate and reallege the allegations of paragraphs 1 through 27 of the Amended Complaint as paragraphs 1 through 27 of this Count I.

28. This action arises under Section 1962(c) of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §1962(c), and is brought against defendants Faestel, FII and MWE only.

30. Petren is an enterprise engaged in and whose activities affect interstate and foreign commerce.

31. Each defendant was employed by or associated with Petren at the time the acts complained of herein occurred.

32. Each defendant conducted and participated, either directly or indirectly, in the conduct of Petren affairs through a pattern of racketeering activity, in violation of 18 U.S.C. §1962(c).

33. Each defendant combined, conspired and agreed to conduct the affairs of Petren through a pattern of racketeering activity in violation of 18 U.S.C. §1962(d).

34. The pattern of racketeering activity through which the defendants conducted and participated in the affairs of Petren extended over a twenty month period and involved numerous and repeated acts of securities fraud generally described as follows:

(a) From March, 1981, through October, 1982, the defendants participated in and promoted five separate and distinct limited partnerships. In each instance, Petren either acted as the managing general partner or held a substantial interest in the managing general partner. During this period, and thereafter, Petren derived most, if not all, of its income from the various limited partnerships.

(b) The five limited partnerships, were as follows:

Petren 1981A—March, 1981 (Petren was managing general partner);

Petren 1981B—June, 1981 (Petren was managing general partner);

Petren Drilling Rig Limited—1981 (Petren 1981 Drilling)—November, 1981 (Petren owned 50% interest in managing general partner);

Petren 1982A Oil and Gas Program (Petren 1982A)—May, 1982 (Petren was managing general partner).

Petren 1982B Oil and Gas Program (Petren 1982B); October, 1982 (Petren managing general partner).

(c) In connection with each limited partnership, Faestel, FII or persons acting on their behalf offered and sold limited partnership interests to various investors.

Each of the limited partnership interests sold were securities within the meaning of Section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. §78c(a)(10), and Section 2(1) of the Securities Act of 1933, 15 U.S.C. §77b(1), and were sold through means and instrumentalities of interstate commerce;

(d) In connection with the sale of the limited partnership interests, one or more of the defendants prepared and distributed to prospective investors Offering Memoranda which contained material misrepresentations and/or omitted to include material facts. Specifically:

(i) In connection with the Petren 1981A offering defendants Faestel, FII and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the material facts described in paragraph 17 above.

(ii) In connection with the Petren 1981B offering defendants Faestel, FII and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the facts described in paragraph 17 above.

(iii) In connection with the Petren 1981 Drilling offering defendants Faestel and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the facts described in paragraph 17 above. In addition, in the Offering Memoranda, said defendants specifically represented that Faestel had made detailed representations to MWE as to his personal net worth and liquidity and that nothing had come to the attention of MWE which would cause them to question the validity of Mr. Faestel's

representations. In fact, at the time the Offering Memoranda were prepared, Faestel and MWE knew that Faestel was, and had been, in default on substantial loans from the Northern Trust and was experiencing extreme financial difficulties.

(iv) In connection with the Petren 1982A offering, defendants Faestel and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the facts described in paragraph 17, above, and which also failed to disclose that shortly before the offering, Petren had terminated its president and chief petroleum engineer for incompetence and recklessness in analyzing and recommending oil and gas prospects for the Petren 1981A and Petren 1981B limited partnerships. In addition, in the Petren 1982A Offering Memoranda, the defendants falsely represented that the Petren 1981A and Petren 1981B limited partnerships were each anticipating substantial future income and a significant return on investment when, at that time, these defendants knew that those limited partnerships had little or no chance to realize any substantial income or return on investment.

(v) In connection with the Petren 1982B offering, Faestel and MWE prepared for distribution to investors Offering Memoranda which failed to disclose the facts described in paragraphs 17 and 34(d)(iv) above, and which also failed to disclose that, at that time, both Faestel and FII were in default on numerous loans in addition to the Northern Trust loans and were essentially insolvent. In addition, in the Petren 1982B Offering

Memoranda, Faestel and MWE also again misrepresented the potential earnings and return on investment of the Petren 1981A and Petren 1981B limited partnerships, claiming falsely that those partnerships could expect substantial income and return on investment.

(d) In making the misrepresentations and/or failing to disclose the omitted facts described above, each defendant acted either with the intent to defraud or recklessly.

(e) By preparing and circulating false and misleading Offering Memoranda in connection with the sale of limited partnership interests described above, the defendants, in each instance, violated Section 10(b) of the Securities Exchange Act and §Rule 10b-5, and Section 17(a) of the Securities Act of 1933.

35. Plaintiffs have been injured in their business and property by reason of the defendant's violations of 18 U.S.C. sec. 1962(c) and (d).

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants Faestel, FII and MWE for threefold the damages plaintiffs sustained as a result of defendants' violations of 18 U.S.C. sec. 1962(c) and (d);

B. Award plaintiffs, and order said defendants to pay, the full cost of this action, including reasonable attorneys fees; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

## COUNT II

### ACTION FOR VIOLATIONS OF SECTION 1962(a) OF THE RACKATEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT

1-27. Plaintiffs incorporate and reallege the allegations or paragraphs 1 through 27 of the Amended Complaint as paragraphs 1 through 27 of this Count II.

28. This action arises under Section 1962(a) of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §1962(a), and is brought against defendant Petren only.

29. Plaintiffs incorporate and reallege the allegations of paragraph 34(a) through (e) of Count I, which described the pattern of racketeering activity involved in this case, as paragraph 29 of this Count II.

30. Defendant Petren has received income derived directly or indirectly from the pattern of racketeering activity described in paragraph 29 above.

31. Defendant Petren is an enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

32. Defendant Petren has used, directly or indirectly, the income it received from the pattern of racketeering activity described above in the establishment and operation of its affairs, in violation of 18 U.S.C. §1962(a).

33. Plaintiffs have been injured in their business and property by reason of Petren's violation of 18 U.S.C. §1962(a).

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendant Petren for threefold the damages plaintiffs sustained as a result of defendants' violations of 18 U.S.C. sec. 1962(a);

B. Award plaintiffs, and order said defendant to pay, the full cost of this action, including reasonable attorneys fees; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

## COUNT III

### ACTION FOR DEFENDANTS' VIOLATIONS OF THE ILLINOIS CONSUMER FRAUD AND DECEPTIVE PRACTICES ACT

1. This action arises under the Illinois Consumer Fraud and Deceptive Business Practices Act ("Illinois Consumer Fraud Act"), Ill. Rev. Stat., ch. 121½, §261, *et seq.*

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-29. Plaintiffs incorporate and reallege paragraphs 1 through 27 of the Amended Complaint as paragraphs 3 through 29 of this Count III.

30. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, defendants acted either negligently, recklessly or willfully and wantonly.

31. By their failure, as descibed above, to disclose material facts in connection with the sale to plaintiffs of limited partnership interests in Petren 1981A and Petren 1981B, defendants violated Section 2 of the Illinois Consumer Fraud Act, Ill. Rev. Stat., ch. 121½, §262, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' unlawful conduct, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action, including reasonable attorneys' fees; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

## COUNT IV

### ACTION FOR BREACH OF DEFENDANTS' FIDUCIARY DUTIES

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-29. Plaintiffs incorporate and reallege paragraphs 1 through 27 of the Amended Complaint as paragraphs 3 through 29 of this Count IV.

30. By reason of their status as general partners of Petren 1981A and Petren 1981B, defendants Petren and FII stood in a fiduciary relationship to the limited partners and were obligated to deal fairly, openly and in good faith in connection with all partnership matters, including the sale to plaintiffs of limited partnership interests.

31. By reason of its status as counsel to Petren 1981A and Petren 1981B, Defendant MWE stood in a fiduciary relationship to the limited partners and was obligated to deal fairly, openly and in good faith in connection with all partnership matters, including the sale to plaintiffs of limited partnership interests.

32. By reason of their failure to disclose material facts in connection with the sale of the limited partnership interests, defendants Petren, FII, and MWE breached their fiduciary duties, causing damage to plaintiffs.

33. As a result of its actions and inactions, MWE participated in and aided and abetted Petren and FII in the breach of their fiduciary duties to plaintiffs.

34. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, each defendant acted willfully, wantonly and/or in reckless disregard of the rights and interests of plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' breach of their fiduciary duties, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

## COUNT V

### ACTION FOR COMMON LAW FRAUD

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-29. Plaintiffs incorporate and reallege paragraphs 1 through 27 of the Amended Complaint as paragraphs 3 through 29 of this Count V.

30. The Offering Memoranda prepared by defendants were distributed to plaintiffs with the intent to induce plaintiffs to invest in the limited partnerships.

31. Plaintiff invested in the limited partnerships in reliance on the truth and accuracy of the information contained in the Offering Memoranda.

32. Plaintiffs reliance on the truthfulness and accuracy of the Offering Memoranda was reasonable under the circumstances.

33. The Offering Memoranda were false and misleading due to the non-disclosures of the material facts described above.

34. In failing to disclose the material facts described above, or in aiding and abetting such non-disclosure, each defendant acted willfully, wantonly and/or in reckless disregard of the rights and interests of plaintiffs.

35. By reason of their failure to disclose the material facts described above, defendants cheated and defrauded the plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendants for the amount of damages sustained as a result of defendants' fraud, along with prejudgment interest as the law may allow;

B. Enter judgment in favor of plaintiffs and against defendants for punitive damages in an amount equal to three times the compensatory damage award;

C. Award plaintiffs, and order defendants to pay, the full cost of this action; and

D. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

## COUNT VI

### ACTION FOR NEGLIGENCE AGAINST MWE

1. This action arises under the common law of the State of Illinois.

2. The amount in controversy exceeds the sum of the amount of Ten Thousand Dollars ($10,000), exclusive of interest and costs.

3-29. Plaintiffs incorporate and reallege paragraphs 1 through 27 of the Complaint as paragraphs 3 through 29 of this Count VI.

30. MWE as counsel for Petren 1981A and Petren 1981B, and as the attorneys responsible for the preparation of the Petren 1981A and Petren 1981B Offering Memoranda, had an affirmative duty to independently verify the disclosures made in the Offering Memoranda and ensure full disclosure of all material facts.

31. Plaintiffs were the intended or reasonably foreseeable beneficiaries of MWE's work product, and it was

foreseeable that plaintiffs would rely upon the Offering Memoranda that MWE prepared.

32. By failing to discover and/or disclose the material facts described above, defendant MWE negligently failed to perform its duty to independently verify the disclosures made in the Offering Memoranda and to ensure full disclosure of all material facts, causing damage to plaintiffs.

WHEREFORE, plaintiffs pray that this Court:

A. Enter judgment in favor of plaintiffs and against defendant MWE for the amount of damages sustained as a result of defendant's negligence, along with prejudgment interest as the law may allow;

B. Award plaintiffs, and order said defendant to pay, the full cost of this action; and

C. Grant plaintiffs such other, further and additional relief as the Court may deem just and appropriate.

R. RICHARD BASTIAN, III; B. P. LOUGHRIDGE, M.D.; RONALD D. ROTUNDA; MARCIA ROTUNDA; GENERAL SYNERGY INVESTMENTS, an Oklahoma partnership; GABRIEL FERNANDEZ; J. MAHAR; CMF ASSOCIATES, an Illinois partnership; ALFRED J. HENDRON, JR.; and M.T. DAVISSON

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IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

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No. 88-3299

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R. RICHARD BASTIAN, III, B. P. LOUGHRIDGE, M.D., RONALD D. ROTUNDA, MARCIA ROTUNDA, GENERAL SYNERGY INVESTMENTS, GABRIEL FERNANDEZ, J. MAHAR, CMF ASSOCIATES, ALFRED J. HENDRON, JR. and M. T. DAVISSON,

Plaintiffs-Appellants,

vs.

PETREN RESOURCES CORPORATION, an Illinois Corporation, FAESTEL INVESTMENTS, INC., an Illinois Corporation, DAVID J. FAESTEL, and McDERMOTT, WILL & EMERY, a partnership,

Defendants-Appellees.

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Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division
No. 86 C 2006
Honorable Brian Barnett Duff, Presiding Judge

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## PLAINTIFFS' RESPONSE TO DEFENDANTS' MOTION TO DISMISS PORTION OF APPEAL AND TO STAY BRIEFING PENDING RULING

### INTRODUCTION

Defendants seek to dismiss plaintiffs' appeal from an order entered March 7, 1988, dismissing plaintiffs' claims under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78j(b). Defendants contend that plain-

tiffs "waived" their right to appeal this order by failing to reallege the dismissed claims in an amended complaint plaintiffs subsequently filed.

In making their waiver argument, defendants neglect to point out several relevant facts concerning the circumstances surrounding the dismissal and plaintiffs' ability to replead. They also fail to discuss the significant body of precedent which specifically rejects the waiver rule they propose. Finally, they offer no rationale for a mechanical application of the waiver rule. Instead, they simply suggest that this Court blindly follow the lead of the Ninth Circuit, which is the only court to have recognized and applied the rule.

## FACTS NOT DISCUSSED

Defendants would have this Court believe that plaintiffs were not interested in preserving their right to appeal the dismissal of their Section 10(b) claims and, therefore, intentionally failed to include these claims in their amended complaint. Nothing could be further from the truth.

Plaintiffs' Section 10(b) claims were dismissed because plaintiffs failed to allege "loss causation." *Bastian v. Petren Resources Corporation*, 681 F.Supp. 530, 534 (N.D. Ill. 1988) ("Bastian I"). Loss causation is pleading requirement recently imposed by some courts in Section 10(b) actions which requires the plaintiff to allege and prove that the defendant's misrepresentations and omissions actually "caused" the subsequent decline in the value of the plaintiffs' investments. This Court has twice rejected this causation requirement, most recently in *Rankow v. First Chicago Corporation*, No. 88-1405, Slip Op. at pp. 22-23

(7th Cir. February 24, 1989). *See also LHLC Corporation v. Cluett, Peabody & Company, Inc.*, 842 F.2d 928 (7th Cir.) *cert. denied,* 109 S.Ct. 311 (1988).[1]

What defendants fail to point out is that when Judge Duff allowed plaintiffs leave to amend their Section 10(b) claims, he also threatened to impose sanctions if they did so and failed to include allegations establishing "loss causation." *Bastian I,* 681 F.Supp. at 536. Plaintiffs, who are merely limited partner investors with no access to partnership information other than that supplied by the defendant general partner, were in no position to allege what "caused the subsequent decline in the value of their investment," particularly in the face of Judge Duff's threat of sanctions. It was for this reason that plaintiffs did not attempt to reallege their Section 10(b) claims.

What Plaintiffs did do (although defendants again fail to mention it), was file a motion to certify Judge Duff's ruling for interlocutory appeal pursuant to 28 U.S.C. Sec. 1292(b). But that motion was denied. *Bastian v. Petren Resources Corporation,* 682 F.Supp. 956, 957 (N.D. Ill. 1988). Thus, plaintiffs were left in a position where they could not appeal the dismissal of their Section 10(b) claims until a final judgment was entered. Refiling the same claims and being subjected to possible sanctions would not have helped the situation. Any suggestion that under these circumstances plaintiffs "deliberately" waived their right to appeal is simply contrary to the facts.

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[1] Defendants' belated motion to dismiss this appeal (filed almost four months after the filing of Notice of Appeal and *after* they obtained an extension of time to file their brief), was most likely prompted by the recent and dispositive *Rankow* decision. Defendants offer no other explanation for the delay in raising their waiver argument.

THERE IS A SUBSTANTIAL BODY OF LAW WHICH IS DIRECTLY CONTRARY TO DEFENDANTS' "WAIVER ARGUMENT"

Not only is defendants' "waiver" argument unsupported by the facts, it is contrary to most case law and conflicts with the views of the commentators. Only the Ninth Circuit has adopted a waiver rule and even some members of that Court are questioning the rule's continuing validity. *See London v. Coopers & Lybrand,* 644 F.2d 811, 814 (9th Cir. 1981) (stating "we are well aware that other Circuits do not look with favor upon this [waiver] rule, . . . but we as a panel are not at liberty to re-examine its validity.")[2]

Most courts which have considered the waiver rule have flatly rejected it. See, for example:

* *Williamson v. Liverpool & London & Globe Insurance Co.,* 141 F. 54, 57 (8th Cir. 1905)
* *Blazer v. Black,* 196 F.2d 139, 143-44 (10th Cir. 1952) (holding that "while the pleader who amends or pleads over waives his objections to the ruling of the court on indefiniteness, incompleteness or insufficiency, or mere technical defects in pleadings, he does not waive his exception to the ruling which strike 'a vital blow to a substantial part' of his cause of action.")
* *Wilson v. First Houston Investment,* 566 F.2d 1235, 1237-38 (5th Cir. 1978) (holding that a plaintiff, who filed an amended complaint after a dis-

[2] Defendants claim in their memorandum that the Tenth Circuit in *Legett v. Montgomery Ward & Co.,* 178 F.2d 436 (10th Cir. 1949), and the Sixth Circuit in *Grubs v. Smith,* 86 F.2d 275 (6th Cir.) *cert. denied,* 300 U.S. 658 (1936), also adopted a waiver rule similar to that proposed by defendants, but a careful reading of those decisions shows they did not.

> missal with leave to amend, was not barred from raising on appeal the correctness of the dismissal order.)

The "waiver" rule adopted by the Ninth Circuit was most recently criticized in *United States v. Bonanno Organized Crime Family*, 695 F.Supp. 1426, 1433 (S.D.N.Y. 1988) where the court called the rule "questionable." Other criticism of the rule can be found in G. C. Wright and A. Miller, *Federal Practice & Procedure*, Section 1476 at 393-4 (1971) and in 3 J. Moore, Moore's Federal Practice, para. 15.08[8] at 15-97 (2d Ed. 1987). As Wright & Miller explain:

> A rule that a party waives his objections to the court's dismissal if he elects to amend is too mechanical and seeks to be a rigid application of the concept that a Rule 15(a) amendment completely replaces the pleading it amends. Without more, the action of the amending party should not result in completely denying him the right to appeal the court's ruling. By way of contrast, if the motion to dismiss is denied and defendant answers the denial of his motion to dismiss on an appeal from the ultimate judgment. Similar principles apply to plaintiff when he unsuccessfully moves to strike a defense as legally insufficient and later serves a reply by order of the court. It therefore is not logical to deny a party the right to appeal simply because he decides to abide by the court's order and amend his pleading rather than allowing judgment to be entered against him and taking an immediate appeal."

*Id.* Professor Moore's views are to the same effect.

As these commentators recognize, a rule which requires a party to replead a dismissed claim makes little sense. Once the dismissed claim is realleged, some action must be taken. The claim must either must be answered or dismissed again. *Bienmau v. City of Chicago*, 662 F.Supp.

1297, 1299 (N.D. Ill. 1987). This procedure only creates additional work for the district court and serves no particular purpose.

Moreover, neither the Ninth Circuit nor the defendants have ever attempted to explain how the waiver rule comports with the provisions of Fed.R.Civ.P. 54(b). Rule 54(b) permits a court to direct the entry of a final judgment as to one but fewer than all of the claims or parties. The Rule also provides:

> "In the absence of such determination and direction, any order or other form of decision, however designated, which adjudicates fewer than all the claims or the rights and liabilities of fewer than all the parties shall not terminate the action as to any of the claims or parties, and the order or other form of decision is subject to revision at any time before the entry of judgment adjudicating all the claims and the rights and liabilities of all the parties."

This language clearly suggests that a claim which is dismissed and is not made final under Rule 54(b), automatically survives until final judgment is entered, at which point the dismissal becomes appealable. Rule 54(b) does not require that any special procedures be followed in order to preserve an appeal from a non-final interlocutory dismissal order. No special procedures should be imposed by this Court.

## DEFENDANTS' OFFER NO RATIONALE AND CITE NO AUTHORITY FROM THIS CIRCUIT WHICH SUPPORTS THE ADOPTION OF THE NINTH CIRCUIT WAIVER RULE

Besides a string citation of authority from the Ninth Circuit, defendants suggest no rationale or offer additional authority which supports the application of the waiver rule

in this case. Defendants refer to five decisions from this Circuit which they argue support the adoption of the waiver rule, but none of these cases have anything to do with the "waiver" issue raised in this case.

For example, defendants rely upon *Ericson v. Seamen*, 94 F.2d 437 (7th Cir. 1938). But that decision was based entirely on Illinois law and has nothing whatsoever to do with federal practice and procedure.[3]

*Nisbet v. Van Tuyl*, 224 F.2d 66 (7th Cir. 1955), also cited by defendants, did not involve a waiver issue arising out of the dismissal of a claim which was not included in a subsequent amended pleading. In *Nisbet*, the plaintiff simply elected to replace an original pleading with an amended pleading *before* any substantive rulings on any claim had occurred. The issue of waiver of a prior claim was not presented in *Nisbet* and the decision provides no support for defendants' argument.

The same is true with respect to all of the other Seventh Circuit authority cited by defendants. *See Dempsey v. Guaranty Trust*, 131 F.2d 103, 105 (7th Cir. 1942) (defs.' memo., pp. 5, 9); *Lubin v. Chicago Title & Trust Company*, 260 F.2d 411, 413 (7th Cir. 1958) (defs.' memo, p. 4); and *Buck v. New York Central Railroad*, 275 F.2d 292 (7th Cir. 1960) (defs.' memo, pp. 4, 6).

Defendants' "confusion" argument is equally groundless. Defendants contend that allowing plaintiffs to appeal from the dismissal of claims alleged in the original and amended complaint "creates confusion" as plaintiffs "alternate be-

[3] The Ninth Circuit also relied on *Ericson* in adopting its waiver rule, but obviously this was inappropriate. *Loux v. Rhay*, 375 F.2d 55, 57 (9th Cir. 1967).

tween defending the Complaint and the Amended Complaint." (Defs.' memo, p. 8) The problem with this argument is that defendants' confusion has nothing whatsoever to do with the issue of whether plaintiffs waived their right to appeal by filing an amended complaint.

Moreover, in their brief, plaintiffs do not alternate between the original and amended complaint. Instead, they focus on a single legal issue: whether a party must allege and prove "loss causation" in order to sustain a claim for violations of Section 10(b) or a RICO claim based upon Section 10(b) violations. Plaintiffs concede that they did not allege "loss causation" in either their original or amended complaint. So neither pleading aids them if this court determines that "loss causation" is an essential element of their claims.

## CONCLUSION

Defendants' urge this Court to adopt a highly restrictive procedural rule which finds no support in the Federal Rules and is generally criticized in the cases and literature. The effect of this rule, if applied in this case, would be to preclude the plaintiffs from appealing the dismissal of certain claims which they clearly intended to preserve for appeal. This result would be neither logical nor just.

The Supreme Court has said:

> Rules of practice and procedure are devised to promote the ends of justice, not to defeat them. A rigid and undeviating judicially declared practice under which courts of review would invariably and under all circumstances decline to consider all questions which had not previously been specifically urged would be out of harmony with this policy. Orderly

> rules of procedure do not require sacrifice of the rules of fundamental justice.

*Hormel v. Helvering*, 312 U.S. 552, 557 (1941).

A similar rationale should be applied here. Defendants' motion to dismiss that portion of this appeal which concerns the dismissal of plaintiffs' Section 10(b) claims should be denied and the briefing schedule should be reinstated. Alternatively, this cause should be remanded to the district court to allow Judge Duff an opportunity to reconsider his rulings in light of this Court's recent decision in *Rankow.*

Respectfully submitted,

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